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## IRS Tax Audits

Because the IRS is unable to examine every return, it follows a policy of examining returns which, upon preliminary inspection, indicate the largest possible source of potential tax deficiency.

Returns are rated for audit according to a mathematical formula called the discriminant function system (DIF). Various weights are assigned to separate items on each tax return, thus permitting the ranking of returns for the greatest potential error. The method is based on data the IRS compiled from extensive audits of taxpayers under the Taxpayer Compliance Measurement Program (TCMP). The specific factors entering into the DIF formula are not disclosed by the IRS. However, its general procedure for selecting returns for audit may be found in an IRS classification handbook which is part of the Internal Revenue Manual (Part IV, Audit).

This chapter discusses what may trigger an audit and how you can handle an audit if your return is selected for examination.

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## ¶48.1 Odds of Being Audited

The odds are low that your return will be picked for an audit. The IRS does not have the personnel and resources to examine every return, so it selects those returns which upon preliminary inspection have a high audit potential—those that are most likely to result in a substantial tax deficiency. In recent years, less than 1% of all individual income tax returns have been examined, and the number has been decreasing. However, for self-employed persons the recent trend has been an increase in the percentage of returns.

Audit odds vary greatly depending on your income, profession, type of return, type of transactions reported, and where you live. Individual returns are classified by all income items on the return without regard to losses. Professional or business income reported on Schedule C and farm income reported on Schedule F is classified by total gross receipts, and corporate returns are classified by total assets. Overall audit percentages include correspondence examinations by IRS Service Centers, office examinations by tax auditors, and field examinations by revenue agents.

Your return may command special IRS scrutiny because of your profession, the type of transactions reported, or the deductions claimed. The chances of being audited are greater under the following circumstances:

- Your itemized deductions exceed IRS targets.
- You claim tax-shelter losses.
- You report complex investment or business transactions without clear explanations.
- You receive cash payments in your work that the IRS thinks are easy to conceal, such as cash fees received by doctors or tips received by cab drivers and waiters.
- Business expenses are large in relation to income.
- Cash contributions to charity are large in relation to income.
- You are a shareholder of a close corporation whose return has been examined.
- A prior audit resulted in a tax deficiency.
- An informer gives the IRS grounds to believe that you are omitting income from your return.

**Itemized deductions.** If your itemized deductions exceed target ranges set by the IRS, the chances of being audited increase. The IRS does not publicize its audit criteria for excessive deductions, but it does release statistics showing the average amount of deductions claimed according to reported income. The latest figures released by the IRS based on deductions claimed on 1994 returns are shown in the next column.

### Average Itemized Deductions

<i>Adjusted Gross Income (thousands)</i>	<i>Taxes</i>	<i>Interest</i>	<i>Medical and Dental</i>	<i>Charitable Donations</i>
\$15–20	\$1,992	\$4,901	\$5,329	\$1,326
20–25	2,153	4,874	3,712	1,257
25–30	2,381	5,122	3,396	1,241
30–40	2,815	5,134	3,954	1,392
40–50	3,367	5,667	4,128	1,537
50–75	4,421	6,345	5,368	1,716
75–100	6,260	7,746	9,596	2,315
100–200	9,773	10,288	9,650	3,420
200–500	22,086	17,403	27,835	8,372
500–1,000	50,634	28,056	100,547	21,582

## ¶48.2 Types of Audits

An examination may be held by correspondence, at a local IRS office, or at the taxpayer's place of business, office, or home. An examination at an IRS office is called a desk or office examination; an examination at a place of business or home is called a field examination. When you are contacted by the IRS, you should receive an explanation of the examination process.



### Economic Reality Audits

The IRS targeted the average taxpayer with a new type of audit, which had the characteristic features of a fraud examination, except that it was sanitized with the name “economic reality audit” or “financial status audit.” Taxpayers and practitioners experiencing the audits complained and under pressure the IRS has suspended such audits.

The financial status (FS) audit was aimed at lifestyle, the assumption being that the way one spends was a better gauge of income capacity than a tax return. To go about this, the IRS questioned taxpayers about their living habits on Form 4822, asking for a list of all personal living expenses paid during the audited tax year.

For any further developments, see the Supplement.

In a correspondence audit, the IRS sends you a letter asking for additional information about an item on your return. For example, the IRS may ask you to document a claimed deduction for charitable contributions or medical expenses. If the IRS is not satisfied with your response, you may be called in for an office audit. The IRS also notifies you by letter of mathematical or clerical errors you have made on your return, or if you have failed to report income, such as interest or dividends, that are shown by payers on information returns and matched to taxpayer returns by IRS computers.

The complexity of the transactions reported on a return generally determines whether a return will be reviewed at an office or field examination.

Most audits of individual returns, except for the self-employed, are conducted at IRS offices. An office audit usually covers only a few specific issues which the IRS specifies in its notice to you. For example, the examining agent may only be interested in seeing proof for travel expense deductions or educational expenses.

Field audits generally involve business returns; they are more extensive and time-consuming than office audits and are handled by more experienced IRS agents. For self-employed individuals, most examinations are field audits at their place of business. It is advisable to have a tax professional go over the potential weak spots in your return and represent you at the examination.

## ¶48.3 Preparing for the Audit

After an office audit is scheduled, the first thing to do is look over your return. Refresh your memory. Examine the items the IRS questioned in its notice of audit, and organize your records accordingly. Also check the rest of your return and gather proof for items you are unsure of. At this point, you should take a broad view of your return to anticipate problems you may encounter. Before the actual examination begins, consider possible settlement terms. Assume that the agent will assess additional tax, but establish the range you will consider reasonable. You can always change your mind, but giving some thought beforehand to possible settlement terms will help you later when settlements are actually discussed.

You may authorize an attorney, CPA, enrolled agent, or other individual recognized to practice before the IRS to represent you at the examination without your being there. To do so, give your representative authorization on Form 2848. An attorney or other representative authorized on Form 2848 can perform any acts that you could, including entering into a binding settlement agreement; see the Sample Form 2848 at the end of this chapter.

If you attend the audit, take only the records related to the items questioned in the IRS notice. Do not volunteer extra records; if the agent sees them, it might suggest new areas for investigation.

If you are concerned that there may be a problem of negligence or fraud, see a qualified attorney before you come into contact with an IRS official. The attorney can put your actions in perspective and help protect your legal rights. Besides, what you tell an attorney is privileged information; he or she cannot divulge or be forced to

divulge data you have provided, so you need not be concerned that disclosures to an attorney will jeopardize your position.

A field audit of your business return is likely to involve a comprehensive examination and requires careful preparation. Together with your tax adviser, go over your return for potential areas of weakness. For example, the agent is likely to question deductions you have claimed for business travel. If you are an incorporated professional, the corporation's deductions for expenses of company-owned cars or planes will probably be reviewed. The agent may suspect that a portion of these business deductions are actually nondeductible personal travel costs; be prepared to substantiate the business portion of your total mileage and operating expenses.

Make sure that the examination is scheduled far enough in advance for you to get ready. Do not let the IRS hurry you into an examination until you are prepared. In some localities, particularly rural areas, the IRS may give short notice in scheduling a field audit. An agent may even appear at your home or place of business and try to begin the audit immediately. Resist this pressure and reschedule the meeting at your convenience.

Under the Taxpayer Bill of Rights (¶48.8), the IRS is generally required to hold an office audit at the office located nearest to your home. The IRS generally may not conduct a field audit at the site of a small business if the audit would essentially require the shutting down of the business, unless a direct visit is necessary to determine inventory or verify assets.

## ¶48.4 Handling the Audit

If you have authorized someone to represent you at the examination, your representative may appear at the examination without you. If the IRS wants to question you, it must issue you an administrative summons. If you are present and questioned, you may stop the examination to consult with counsel, unless the examination is pursuant to an administrative summons.

Audits conducted at an IRS office may conclude quickly because they usually involve only a few specific issues. In some cases, the audit may take less than an hour. The key to handling the audit is advance preparation. When you arrive at the IRS office, be prepared to produce your records quickly. Records should be organized by topic so that you do not waste time leafing through pages for a receipt or other document.

If the agent decides to question an item not mentioned in the notice of audit, refuse politely but firmly to answer the questions. Tell the agent that you must first review your records. If the agent insists on pursuing the matter, another meeting will have to be scheduled. The agent might decide it is not worth the time and drop the issue.

Common sense rules of courtesy should be your guide in your contacts with the agent. Avoid personality clashes; they can only interfere with a speedy and fair resolution of the examination. However, be firm in your approach and, if the agent appears to be unreasonable in his or her approach, make it clear that—if necessary—

you will go all the way to court to win your point. A vacillating approach may weaken your position in reaching a settlement.

If the IRS has scheduled a field audit, ask that the examination be held at your representative's office. If you have not retained professional help and the examination takes place on your business premises, do not allow the agent free run of the area: Provide the agent with a comfortable work area for examining your records. If possible, the workplace should be isolated so that the agent can concentrate on the examination without being distracted by office operations that might spark questions. Tell your employees not to answer questions about your business or engage in small talk with the agent. As with an office audit, help speed along the field examination by having prepared your records so that requested information can be quickly produced.

**Recording the examination.** You have the right to make an audio recording of any interview with an IRS official. Video recordings are not permitted. No later than 10 calendar days before the interview, give written notice to the agent conducting the interview that you will make a recording. Later requests are at the discretion of the IRS. You must pay for all recording expenses and supply the equipment. The IRS may also make a recording of the interview, upon giving notice of at least 10 calendar days. However, IRS notice is not necessary if you have already submitted a request to make a recording. You have the right to obtain a transcript, at your own expense, of any recording made by the IRS. Generally, a request for a copy must be received by the IRS agent within 30 calendar days after the recording, although later requests may be honored.

## ¶48.5 Agreeing to Audit Changes

After the audit, the agent will discuss proposed changes either with you or your representative.

If you agree with the agent's proposed changes, you will be asked to sign a Form 870, which, when signed, permits an immediate assessment of a deficiency plus penalties and interest, if due. The Form 870 is called "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment."

Before deciding whether to sign the Form 870, consider that, by signing, you are giving up your right of appeal to both an IRS Appellate Conference and the Tax Court. However, you may still file a refund suit in a federal district court or in the Court of Federal Claims unless you have agreed not to do so on the Form 870.

If you believe that you have done as well or better than expected regarding the proposed deficiency, you can bring the case to a close by signing the Form 870, but the agent's supervisor must also approve the assessment.

By signing the form, you limit the amount of interest charges added to the deficiency; interest stops running within 30 days after the date it is signed. A signed Form 870 does not prevent the IRS from reopening the case to assess an additional deficiency. If on review the deficiency is increased, you will receive a revised Form 870. You can refuse to sign the form. The signed first form has the effect of stopping the interest on the original deficiency. As a matter of practice, however, waivers of acceptances ordinarily result in closing of the case.

It is possible, although unlikely, that upon examining your return, the agent will determine that you are due a refund. In this situation, a signed Form 870 is merely an acknowledgment of the overassessment. You should file a protective refund claim even if you sign the Form 870 acknowledging the overassessment. Generally, the agent will process the refund, but if he or she fails to do so or the review staff puts it aside for some reason and the limitations period expires, the refund will be lost. The refund claim will protect you from such a mishap.

The payment of tax before the deficiency notice (90-day letter) is mailed is, in effect, a waiver of the restrictions on assessment and collection. If the payment satisfies your entire tax liability for that year, you cannot appeal to the Tax Court. You must sue for a refund in either federal district court or the Court of Federal Claims.

## ¶48.6 Disputing the Audit Changes

If you disagree with the agent and the examination takes place in an IRS office, you may ask for an immediate meeting with a supervisor to argue your side of the dispute. If an agreement is not reached at this meeting or the audit is at your office or home, the agent prepares a report of the proposed adjustments. You will receive a 30-day letter in which you are given the opportunity to request a conference. You may decide not to ask for a conference and await a formal notice of deficiency.

If your examination was conducted as an office audit or by correspondence, or the disputed amount does not exceed \$2,500, you do not have to prepare a written protest for a conference. The written protest presents your reason for disagreeing with the agent's report. See IRS Publication 5, "Appeal Rights and Preparation of Protests for Unagreed Cases."

At the conference you may appear for yourself or be represented by an attorney or other agent, and you may bring witnesses. The conference is held in an informal manner and you are given ample opportunity to present your case.

If you cannot reach a settlement, you will receive a Notice of Deficiency, commonly called a 90-day letter. In it, you are notified that at the end of 90 days from the date it was mailed, the government will assess the additional tax.

**Going to court.** When you receive a 90-day letter, if you are still convinced that your position is correct, you may take your case to one of three courts. You may within 90 days file a petition with the Tax Court; *or* you may pay the additional tax, file a refund claim for it, and—after the refund claim is denied—sue for a refund in a federal district court or the U.S. Court of Federal Claims.

Generally, the decision to litigate should be considered by an experienced tax practitioner.

The Tax Court has a small tax case procedure for deficiencies of \$10,000 or less. Such cases are handled expeditiously and informally. Cases may be heard by appointed special trial judges. A small claim case may be discontinued at any time before a decision, but the decision when made is final. No appeal may be taken.

**Penalty for frivolous court action.** If you bring a frivolous case to the Tax Court or unreasonably failed to discuss your position within the IRS audit procedures, the Tax Court may impose a penalty of up to \$25,000. If an attorney unreasonably multiplies Tax Court proceedings, the attorney may be required to pay excess court costs or attorneys' fees incurred because of the resulting delay. Furthermore, if you appeal a Tax Court decision and the appeals court finds that the appeal was frivolous, you may be penalized.

## ¶48.7 Recovering Legal Fees

In a tax dispute, you may feel that the IRS has taken an unreasonable position that forced you to incur legal fees and other expenses to win your case. You may be able to recover all or part of your costs under the following rules in a civil tax case.

**Cases commenced after July 30, 1996.** Generally, taxpayers who win their cases in the Tax Court or any other federal court may recover up to \$110 an hour for attorneys' fees plus related litigation expenses. After 1996, the \$110 hourly limit may be increased by an inflation factor. If the following requirements are satisfied, attorneys' fees in a declaratory judgment proceeding may be recovered.

All administrative remedies with the IRS must be exhausted to recover litigation and administrative costs, but this does not include having to agree to an extension of time for the assessment of tax. An award may be based on unjustified conduct by the IRS during pre-trial administrative proceedings as well as on IRS conduct after litigation begins.

Individuals *may not* recover legal fees if their net worth exceeds \$2 million. No recovery is allowed to sole proprietors, partnerships, and corporations if net worth exceeds \$7 million or they have more than 500 employees.

The \$110 per hour (or indexed amount after 1996) recovery for fees of an attorney or other qualified representative may be increased if the court determines that a higher rate is justified. A higher rate may be based on the high cost of attorneys in urban areas, or the limited availability of attorneys.

To recover administrative or litigation costs, you must "substantially prevail" as to the key issues in the case or the amount of tax involved. If you do, you will be entitled to a recovery unless the IRS proves that it was "substantially justified" in maintaining the position that it did. The Tax Court and other courts have interpreted "substantially justified" to be a reasonableness standard. The IRS is presumed not to be "substantially justified" if it does not follow its own published regulations, revenue rulings, or procedures, notices, announcements, or a private ruling issued to the taxpayer. The IRS may try to rebut the presumption. The reasonableness of an IRS position at the administrative stage is determined as of the earlier of two dates: (1) the date you received notice of an IRS decision from its appeals office, and (2) the date of the deficiency notice. If the IRS position as of the earlier date was not justified and you win your case in Tax Court or other federal court, the court may award the follow-

ing costs incurred on or after that date: (1) administrative fees or similar charges imposed by the IRS; (2) reasonable expenses of expert witnesses; (3) the reasonable cost of any study, analysis, engineering report, test, or project that is necessary for the preparation of the case; and (4) reasonable fees (generally not to exceed \$110 per hour) paid or incurred for the services of a qualified representative in connection with the administrative action.

If your case is settled with the IRS before going to court, the IRS may settle your claim for administrative expenses. If it denies or limits your claim, you may appeal to the Tax Court under the informal "small" case procedures.

An award for litigation expenses may also include court costs and other reasonable fees based on prevailing market rates for expert witnesses and special reports, such as an engineer's report necessary to the preparation of your court case. However, the recovery for expert witnesses may not exceed the amount paid by the government to its own expert witnesses. Litigation expenses are recoverable only if you have exhausted administrative remedies within the IRS.

**Cases commenced after November 10, 1988, but before July 31, 1996.** The rules for recovering attorneys' fees and related litigation and administrative proceeding costs are similar to those previously discussed for cases begun after July 30, 1996, but there are some key differences.

The maximum recovery for attorneys' fees is \$75 per hour, unless the court finds that a higher rate is justified. In one case, an award of \$180 per hour was approved by a federal court because of the attorney's specialized skills and the complexity of corporate tax issues involved in the case. However, in another case, the Tax Court refused to allow fees of \$150 per hour, which was the going rate for tax litigation experts in Albuquerque.

To receive attorneys' fees or other litigation or administrative proceeding costs, the burden is on you to prove that the IRS's position was *not* substantially justified. There is no presumption, as there is in cases starting after July 30, 1996, that the IRS was not substantially justified if it did not follow its published rulings or other guidance.

**Suing the IRS for unauthorized collection action.** If an IRS employee recklessly or intentionally disregards the law or IRS regulations when making a tax assessment or taking some other collection action, you may sue the IRS in federal district court for actual economic damages resulting from the IRS employee's misconduct plus certain costs of bringing the action. The lawsuit must be filed within two years of the date your right to sue accrued.

The maximum damage award is \$1 million for actions by IRS officers or employees after July 30, 1996. An award may be reduced if administrative remedies before the IRS are not exhausted. If the IRS action was after November 10, 1988, but before July 31, 1996, the maximum award is \$100,000, and no amount will be awarded if the court determines that administrative remedies were not exhausted. No suit may be brought for IRS actions before November 11, 1988.

According to IRS regulations, actual economic damages that may be recovered are monetary losses you suffer as a direct result of the IRS's unlawful action. For example, a business may lose loyal



customers and suffer an actual cash loss if the IRS's action damages the business's reputation. Other actual expenses could include the cost of renting a house or a car if the IRS puts a lien on or seizes your property, or loss of income due to the garnishment of your paycheck. Damages from the IRS for loss of reputation, inconvenience, or emotional distress are allowed only to the extent that they result in such actual monetary loss.

The IRS defines "costs of action" that you may recover as (1) fees of the clerk and marshal; (2) fees of the court reporter; (3) fees and disbursements for printing and witnesses; (4) copying fees; (5) docket fees; and (6) compensation for court-appointed experts and interpreters.

Litigation costs and administrative proceeding costs are not treated as "costs of the action." However, if the IRS denies your administrative claim for damages and you successfully sue in federal district court, you are considered a "prevailing party" and may recover attorneys' fees, related litigation expenses, and administrative costs before the IRS as previously discussed.

**Warning:** If you start a court action and the court holds that it is frivolous, you may be penalized up to \$10,000.

**IRS failure to release lien.** A suit for damages may also be brought in federal district court against the IRS if IRS employees improperly fail to release a lien on your property. Before you sue, you must file an administrative claim for damages. The lawsuit must be filed within two years after your claim arose. You may sue for actual economic damages plus costs of the action; the types of damages that may be recovered are similar to those previously discussed for suing the IRS for unauthorized collection actions.

## ¶48.8 Taxpayer Bill of Rights

The provisions of the Taxpayer Bill of Rights are generally intended to protect taxpayers during IRS examinations and tax collection procedures. The second installment of such provisions, the Taxpayer

### Taxpayer Bill of Rights (also see new law provisions at ¶48.8)

Item—	Rule—
<b>Being informed of your rights</b>	If the IRS sends you notice of a deficiency or collection action, it must include a nontechnical statement of your rights during an audit and an explanation of IRS collection procedures and appeals procedures within the IRS and the courts.
<b>Having a representative handle your case</b>	To represent you at an examination, you may give a written power of attorney to a lawyer, CPA, or enrolled agent or actuary qualified to practice before the IRS. You do not have to attend the examination unless the IRS issues an administrative summons requesting your presence.
<b>Recording your examination</b>	As discussed at ¶48.4, you may, at your own expense, make an audio recording of an interview if you give advance notice to the IRS. The IRS may also record an interview; you must be given prior notice and an opportunity to obtain a transcript by reimbursing the IRS for the printing costs.
<b>Getting hardship relief from the IRS</b>	If the IRS is threatening to seize your property or take some other collection measure that could cause you significant hardship, you may apply for a Taxpayer Assistance Order by filing Form 911 with the Problem Resolution Office in the IRS district where you live. While the Problem Resolution Officer or the IRS Taxpayer Advocate reviews your application, enforcement actions are suspended.
<b>Relying on erroneous IRS advice</b>	You may avoid penalties but not tax or interest if you rely on written IRS advice when preparing a return and the advice turns out to be erroneous. You must provide specific information to the IRS in writing when making a request for advice. You may no longer rely on the advice if the IRS gives you written notice that the advice is no longer the IRS position; if it takes a contrary position in regulations or in a published revenue ruling, procedure, or notice; or if the law is changed by a Supreme Court decision or tax treaty. If you have not been notified of a change in IRS position but a penalty is nevertheless assessed, file Form 843 for an abatement of the penalty and attach copies of your request for advice and the IRS's erroneous advice. Write at the top of Form 843: "Abatement of penalty or addition to tax pursuant to Section 6404(f)." If the penalty has been paid, file Form 843 as a refund claim.
<b>Property exempt from IRS seizure</b>	<p>The weekly amount of wages exempt from IRS levy (seizure) is equal to your standard deduction plus allowable personal exemptions divided by 52.</p> <p>For pre-1997 levies, the amount of personal property exempt from IRS seizure is \$1,650 for fuel, provisions, furniture, and household effects and \$1,000 for books, tools, machinery, or equipment used in a business or profession.</p> <p>A personal residence is exempt from IRS levy, unless an IRS district director or assistant district director personally authorizes it in writing or the Treasury Secretary finds that collection of the tax would be jeopardized if the residence is not seized.</p> <p>Before the IRS may seize property, it must give 30 days' notice. The notice must clearly describe the levy procedures, your options to avoid the levy, such as beginning installment payments for overdue tax, and steps for redeeming property if property is seized by the IRS.</p> <p>A bank will hold your account for 21 days after receiving notice of an IRS levy before turning over the money to the IRS. The 21-day freeze allows you time to contact the IRS.</p> <p>If the IRS attempts to levy your property after you have paid the underlying tax liability, the statute of limitations has expired, or if the property is exempt under bankruptcy rules, you should appeal to the IRS to release the levy. Send a written statement to the District Director of the IRS district in which the lien was filed, explaining your grounds for appeal.</p>
<b>Recovering attorney fees in IRS administrative proceedings</b>	As discussed at ¶48.7, reasonable legal costs incurred during certain administrative proceedings may be recovered if you prevail at such an administrative proceeding.

Bill of Rights 2, was signed into law on July 30, 1996. The new law increases the maximum award for attorneys' fees and damages for reckless IRS collections, as discussed at ¶48.7. Here are other new law highlights:

- IRS-designated private delivery services may now be relied upon by taxpayers for their postmark for purposes of having timely filed tax-related documents.
- The Taxpayer Ombudsman is replaced with the position of Taxpayer Advocate to help individuals resolve problems with the IRS. The Taxpayer Advocate is responsible for identifying problem areas and reporting them to tax-writing committees that propose administrative and legislative changes to correct these problems. The new position has broader authority to take action for taxpayers who would otherwise suffer a significant hardship as a result of IRS administration of the tax laws.
- Effective January 30, 1997, the IRS is required to notify taxpayers 30 days before altering, modifying, or terminating any installment agreement for any reason, except when tax collection is in jeopardy.
- The IRS may abate interest charged to a taxpayer if unreasonable errors or delays were caused by IRS employees performing "managerial or ministerial" acts. The Tax Court has jurisdiction to review whether IRS failure to abate interest for an eligible taxpayer was an abuse of discretion.
- The interest-free payment deadline for taxpayers to pay tax after receiving notice and demand is upped from 10 to 21 calendar days if the deficiency is less than \$100,000 and to 10 business days if the deficiency is at least \$100,000. The interest provisions are effective for any notice and demand after December 31, 1996.
- Property exempt from levy after 1996 is increased from \$1,650 to \$2,500 for personal property and from \$1,100 to \$1,250 for books and business tools.
- Because the resources of the IRS are limited, collection of small delinquent accounts may not occur for several years. After 1996, the IRS is required to send annual reminders to taxpayers with outstanding delinquent accounts.

Form 2848 (Front and Back) goes here. See FPO for placement